alien or foreign corporation that makes an election generally must provide the partnership a Form W–8ECI, ''Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States,'' and attach to such form a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). However, if the nonresident alien or foreign corporation has already submitted a valid form to the partnership that establishes such partner's foreign status, the partner shall furnish the partnership a copy of the election (or a statement that indicates that the nonresident alien or foreign corporation will make the election). To the extent the partnership has income to which the election pertains, the partnership shall treat such income as effectively connected income subject to withholding under section 1446. See also §1.1446–2.

(e) *Effective dates.* This section shall apply for taxable years beginning after December 31, 1966, except the last four sentences of paragraph (d)(3) of this section shall apply to partnership taxable years beginning after May 18, 2005, or such earlier time as the regulations under §§1.1446–1 through 1.1446–5 apply by reason of an election under §1.1446–7. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44222, Dec. 23, 1974, as amended by T.D. 9200, 70 FR 28717, May 18, 2005]

§1.871–11 Gains from sale or exchange of patents, copyrights, or similar property.

(a) *Contingent payment defined.* For purposes of section 871(a)(1)(D), section 881(a)(4), §1.871–7(c)(1)(iv), §1.881–2(c)(1)(iii), and this section, payments which are contingent on the productivity, use, or disposition of property or of an interest therein include continuing payments measured by a percentage of the selling price of the products marketed, or based on the number of units manufactured or sold, or based in a similar manner upon production, sale or use, or disposition of the property or interest transferred. A payment which is certain as to the amount to be received, but contingent as to the time of payment, or an installment payment of a principal sum agreed upon in a transfer agreement, shall not be treated as a contingent payment for purposes of this paragraph. For the inapplication of section 1253 to certain amounts described in this paragraph, see paragraph (a) of §1.1253–1.

(b) *Payments treated as contingent on use.* Pursuant to section 871(e), if more than 50 percent of the gain of a nonresident alien individual or foreign corporation for any taxable year from the sale or exchange after October 4, 1966, of any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property, or of any interest in any such property, is from payments which are contingent on the productivity, use, or disposition of such property or interest, all of the gain of such individual or corporation for the taxable year from the sale or exchange of such property or interest are, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), or section 1442(a), and the regulations thereunder, to be treated as being from payments which are contingent on the productivity, use, or disposition of such property or interest. This paragraph does not apply for purposes of determining under section 871(b)(1) or 882(a)(1) the tax of a nonresident alien individual or foreign corporation on income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

(c) *Sale or exchange.* A sale or exchange for purposes of this section includes, but is not limited to, a transfer by an individual which by reason of section 1235, relating to the sale or exchange of patents, is considered the sale or exchange of a capital asset. The provisions of section 1253, relating to transfers of franchises, trademarks, and trade names, do not apply in determining whether a transfer is a sale or exchange for purposes of this section.

(d) *Recovery of adjusted basis.* For purposes of determining for any taxable year the amount of gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4), payments received by the nonresident alien individual or foreign

corporation during such year must be reduced by amounts representing recovery of the taxpayer's adjusted basis of the property or interest which is sold or exchanged. Where the taxpayer receives in the same taxable year payments which, without reference to section 871(e) and this section, are not contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged and payments which are contingent on the productivity, use, or disposition of the property or interest which is sold or exchanged, the taxpayer's unrecovered adjusted basis in the property or interest which is sold or exchanged must be allocated for the taxable year between such payments on the basis of the gross amount of each such type of payments. Where the taxpayer receives in the taxable year only payments which are not so contingent or only payments which are so contingent, the taxpayer's unrecovered basis must be allocated in its entirety to such payments for the taxable year.

(e) *Source rule.* In determining whether gains described in section 871(a)(1)(D) or 881(a)(4) and paragraph (b) of this section are received from sources within the United States, such gains shall be treated, for purposes of section 871(a)(1)(D), section 881(a)(4), section 1441(b), and section 1442(a), as rentals or royalties for the use of, or privilege of using, property or an interest in property. See section 861(a)(4), §1.861–5, and paragraph (a) of §1.862–1.

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. (a) A, a nonresident alien individual who uses the cash receipts and disbursements method of accounting and the calendar year as the taxable year, holds a U.S. patent which he developed through his own effort. On December 15, 1967, A enters into an agreement of sale with M Corporation, a domestic corporation, whereby A assigns to M Corporation all of his U.S. rights in the patent. In consideration of the sale, M Corporation is obligated to pay a fixed sum of $60,000, $20,000 being payable on execution of the contract and the balance payable in four annual installments of $10,000 each. As additional consideration, M Corporation agrees to pay to A a royalty in the amount of 2 percent of the gross sales of the products manufactured by M Corporation under the patent. A is not engaged in trade or business in the United States at any time during 1967 and 1968. His adjusted basis in the patent at the time of sale is $28,800.

(b) In 1967, A receives only the $20,000 paid by M Corporation on the execution of the contract of sale. No gain is realized by A upon receipt of this amount, and his unrecovered adjusted basis in the patent is reduced to $8,800 ($28,800 less $20,000).

(c) In 1968, M Corporation has gross sales of $600,000 from products manufactured under the patent. Consequently, for 1968, M Corporation pays $22,000 to A, $10,000 being the annual installment on the fixed payment and $12,000 being payments under the terms of the royalty provision. A's recognized gain for 1968 is $13,200 ($22,000 reduced by the unrecovered adjusted basis of $8,800). Of the total gain of $13,200, gain in the amount of $6,000 ($10,000 − [$8,800×$10,000/$22,000]) is considered to be from the fixed installment payment and of $7,200 ($12,000 − [$8,800×$12,000/$22,000]) is considered to be from the royalty payment. Since 54.5 percent ($7,200/$13,200) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, all of the $13,200 gain recognized in 1968 is treated, for purposes of section 871(a)(1)(D) and section 1441(b), as being from payments which are contingent on the productivity, use, or disposition of the patent.

Example 2. (a) F, a foreign corporation using the calendar year as the taxable year and not engaged in trade or business in the United States, holds a U.S. patent on certain property which it developed through its own efforts. Corporation F uses the cash receipts and disbursements method of accounting. On December 1, 1966, F Corporation enters into an agreement of sale with D Corporation, a domestic corporation, whereby D Corporation purchases the exclusive right and license, and the right to sublicense to others, to manufacture, use, and/or sell certain devices under the patent in the United States during the term of the patent. The agreement grants D Corporation the right to dispose, anywhere in the world, of machinery manufactured in the United States and equipped with such devices. Corporation D is granted the right, at its own expense, to prosecute infringers in its own name or in the name of F Corporation, or both, and to retain any damages recovered.

(b) Corporation D agrees to pay to F Corporation annually $5 for each device manufactured under the patent during the year but in no case less than $5,000 per year. In 1967, D Corporation manufactures 2,500 devices under the patent; and, in 1968, 1,500 devices. Under the terms of the contract D Corporation pays to F Corporation in 1967 $12,500 with respect to production in that year and $7,500 in 1968 with respect to production in

that year. F Corporation's basis in the patent at the time of the sale is $17,000.

(c) With respect to the payments received by F Corporation in 1967, no gain is realized by that corporation and its unrecovered adjusted basis in the patent is reduced to $4,500 ($17,000 less $12,500).

(d) With respect to the payments received by F Corporation in 1968, such corporation has recognized gain of $3,000 ($7,500 reduced by unrecovered adjusted basis of $4,500). Of the total gain of $3,000, gain in the amount of $2,000 ($5,000 − [$4,500×$5,000/$7,500]) is considered to be from the fixed installment payment and of $1,000 ($2,500 − [$4,500× $2,500/$7,500]) is considered to be from payments which are contingent on the productivity, use, or disposition of the patent. Since 33.3 percent ($1,000/$3,000) of the gain recognized in 1968 from the sale of the patent is from payments which are contingent on the productivity, use, or disposition of the patent, only $1,000 of the $3,000 gain for that year constitutes gains which, for purposes of section 881(a)(4) and section 1442(a), are from payments which are contingent on the productivity, use, or disposition of the patent. The balance of $2,000 is gain from the sale of property and is not subject to tax under section 881(a).

(g) *Effective date.* This section shall apply for taxable years beginning after December 31, 1966, but only in respect of gains from sales or exchanges occurring after October 4, 1966. There are no corresponding rules in this part for taxable years beginning before January 1, 1967.

[T.D. 7332, 39 FR 44224, Dec. 23, 1974]

§ 1.871–12 Determination of tax on treaty income.

(a) *In general.* This section applies for purposes of determining under §1.871–7 or §1.871–8 the tax of a nonresident alien individual, or under §1.881–2 or §1.882–1 the tax of a foreign corporation, which for the taxable year has income described in section 872(a) or 882(b) upon which the tax is limited by an income tax convention to which the United States is a party. Income for such purposes does not include income of any kind which is exempt from tax under the provisions of an income tax convention to which the United States is a party. See §§1.872– 2(c) and 1.883–1(b). This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year.

(b) *Definition of treaty and nontreaty income*—(1) *In general.* (i) For purposes of this section the term ''treaty income'' shall be construed to mean the gross income of a nonresident alien individual or foreign corporation, as the case may be, the tax on which is limited by a tax convention. The term ''non-treaty income'' shall be construed, for such purposes, to mean the gross income of the nonresident alien individual or foreign corporation other than the treaty income. Neither term includes income of any kind which is exempt from the tax imposed by chapter 1 of the Code.

(ii) In determining either the treaty or nontreaty income the gross income shall be determined in accordance with §§1.872–1 and 1.872–2, or with §§1.882–3 and 1.883–1, except that in determining the treaty income the exclusion granted by section 116(a) for dividends shall not be taken into account. Thus, for example, treaty income includes the total amount of dividends paid by a domestic corporation not disqualified by section 116(b) and received from sources within the United States if, in accordance with a tax convention, the dividends are subject to the income tax at a rate not to exceed 15 percent but does not include interest which, in accordance with a tax convention, is exempt from the income tax. In further illustration, neither the treaty nor the nontreaty income includes interest on certain governmental obligations which by reason of section 103 is excluded from gross income, or interest which by reason of a tax convention is exempt from the tax imposed by chapter 1 of the Code.

(iii) For purposes of applying any income tax convention to which the United States is a party, original issue discount which is subject to tax under section 871(a)(1)(C) or 881(a)(3) is to be treated as interest, and gains which are subject to tax under section 871(a)(1)(D) or 881(a)(4) are to be treated as royalty income. This subdivision shall not apply, however, where its application would be contrary to any treaty obligation of the United States.

(2) *Application of permanent establishment rule of treaties.* In applying this section with respect to income which is